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Function No. 10000 - Overview	<b>TOPIC</b> <b>INTERNAL CONTROL</b>
Section No. 10300 - Internal Control Guidance	<b>DATE</b> September 1998

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## Overview

### Introduction

This topic provides guidelines to assist State agencies and institutions in implementing internal control programs. Internal controls relating to specific topics such as accounts receivable and prompt payment are covered in corresponding CAPP topics.

### Policy

The responsibility for the establishment and maintenance of sound internal control in agencies resides with agency management. Such controls must take into consideration the requirements promulgated by central agencies in the form of policies and procedures as well as adherence to the controls built into central, Statewide systems. Agencies are required to develop a formal program to evaluate the operating environment and ensure adequate internal controls are maintained over financial assets. The components of such a program are described in this topic. All agencies and institutions must certify to the Department of Accounts (DOA) that agency management acknowledges its responsibility for internal control, and represents that a cost-effective system of internal control is in place and functioning to adequately safeguard the assets of the agency and reasonably assure the proper recording of the agency's financial transactions. **(See Exhibit I and II as applicable).**

### Statements of Internal Control

The following two statements are representative of what should be included in an agency's transmittal letter regarding internal controls.

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## EXHIBIT I

### **STATEMENT OF INTERNAL CONTROL FOR INCLUSION IN THE TRANSMITTAL LETTER OF AN AGENCY OR INSTITUTION'S ANNUAL FINANCIAL STATEMENTS**

#### **Management's Responsibility**

This report has been prepared by (Agency), whose management is responsible for the integrity and objectivity of the financial statements and other information presented herein. The financial statements are considered by management to present fairly the (Agency's) financial position, results of operations and changes in fund balances. We believe the data presented is accurate in all material respects and that all disclosures necessary to enable the reader to obtain a thorough understanding of the (Agency's) financial activities have been included.

In part, the basis for these conclusions relates to our assessment of the internal controls operating within the (Agency). The establishment of such internal controls requires estimates and judgements from management so that, in attaining reasonable assurance as to the adequacy of such controls, the cost of controls should not exceed the benefits obtained. I believe (do not believe)\* the (Agency's) internal controls adequately safeguard its assets and provide reasonable assurance as to the proper recording of financial transactions.

\*Note: If the Agency Head does not believe the internal controls are adequate, a brief statement describing/explaining the weakness should be provided in this transmittal.

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## EXHIBIT II

### **STATEMENT OF INTERNAL CONTROL** **WHEN FINANCIAL STATEMENTS ARE NOT REQUIRED**

#### **Management's Responsibility**

(Agency) management is responsible for the integrity and objectivity of the financial transactions and other information provided to the State Comptroller.

We believe the data provided are accurate in all material respects and that all disclosures necessary to obtain a thorough understanding of the (Agency's) financial activities have been included.

The basis for these conclusions relates to our assessment of the internal controls operating within the (Agency). The establishment of such internal controls requires estimates and judgements from management so that, in attaining reasonable assurance as to the adequacy of such controls, the cost of controls should not exceed the benefits obtained. I believe (do not believe)\* the (Agency's) internal controls adequately safeguard its assets and provide reasonable assurance as to the proper recording of financial transactions.

\*Note: If the Agency Head does not believe the internal controls are adequate, a brief statement describing/explaining the weakness should be provided in this transmittal.

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## Definitions

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**Accounting Controls** Policies and procedures surrounding the activities concerned with authorizing, processing, recording, and reporting financial transactions which operate within the broader control environment of administrative controls. Accounting controls ensure that information resulting from these activities is reliable and useful.

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**Administrative Controls** Broad policies and procedures surrounding all activities carried out by officials to accomplish their objectives (e.g., planning, organizing, monitoring productivity, improving, and ensuring quality control). These controls are necessary to ensure that

- All resources, including personnel, are properly obtained, maintained, and used;
- Decisions regarding the expenditure of funds are made based on reliable information; and,
- Budgets are properly developed and monitored to ensure consistency between planned and actual expenditures.

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**Assessable Unit** Manageable subdivision or segment of an agency or institution which is to be the subject of a risk assessment.

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**Control Objectives** Goals or targets to be achieved for each internal control. Objectives should be tailored to fit the specific operations in each agency.

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**Event Cycle** Processes used to initiate and perform related activities to create the necessary documentation, and to gather and report related data (e.g., accounts payable cycle).

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**General Control Environment** Various factors that can influence the effectiveness of internal controls over program and administrative functions such as an excessive use of a petty cash fund due to heavy travel requirements which may result in bypassing internal controls. This includes the integrity, ethical values, and competence of an agency's employees, management's philosophy and operating style, organization structure, delegation of authority and responsibility, and written policies and procedures.

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## Definitions, Continued

<b>Inherent Risk</b>	Degree to which activities are exposed to the potential for financial loss, inappropriate disclosure or other erroneous conditions. E.g., activities conducted within severe time constraints have greater inherent risk than those, which are not subject to time constraints.
<b>Internal Control</b>	<p>Process effected by management and other personnel designed to provide reasonable assurance that objectives are being achieved in the following three areas:</p> <ul style="list-style-type: none"> <li>• Effectiveness and efficiency of operations,</li> <li>• Reliability of financial reporting, and</li> <li>• Compliance with applicable laws and regulations.</li> </ul>
<b>Internal Control Review</b>	Examination of an operating system to determine whether adequate internal control measures exist and are implemented to prevent or detect the occurrence of potential risks in a cost-effective manner.
<b>Program Controls</b>	<p>Controls surrounding the planning and accomplishing of the agency's programmatic goals and objectives. These represent a further level of detail of administrative controls. Examples of program controls are</p> <ul style="list-style-type: none"> <li>• Routine evaluations of the agency's goals, objectives and activities and the extent to which overall objectives are met, and</li> <li>• Evaluation of how the agency operates to meet their objectives.</li> </ul>
<b>Risk Assessment</b>	Process of determining the relative potential for loss/misuse of an assessable unit's resources due to inadequate control techniques and/or environment factors. The results of the assessment are used to mitigate inherent risks.

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## Internal Control

### Internal Control Activities

A control activity is a technique or mechanism performed to achieve a specific purpose or objective. It is detective, corrective, or preventive and is intended to be a red flag that signals problems that have or may occur. Types of internal control activities include

- Policies,
- Procedures,
- Sequences or combination of procedures,
- Assignments of duties, responsibilities, and authorities,
- Physical arrangements or processes, and
- Combinations of the above.

### Recommended Evaluation Approach

To conduct the evaluation of internal controls, the following approach is recommended.

Step	Action
1	<b>Organize the Process</b> Agency heads are responsible for monitoring the effectiveness of the internal control systems. An agency head should consider assigning an Internal Control Coordinator with overall responsibility to ensure internal control evaluations are performed and sufficient information exists to report on the status of internal controls.

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## Internal Control, Continued

### Recommended Evaluation Approach (continued)

Step	Action
2	<p><b>Segment the Agency</b></p> <p>Because many agencies have large organizational structures and/or complexities in their programs, it is usually difficult to perform a risk assessment and internal control review on the agency as a whole. In these circumstances, it is often desirable to divide the agency into smaller and more manageable units to conduct a meaningful internal control evaluation. These units are termed <i>assessable units</i>.</p> <p>An assessable unit can be defined by various methodologies such as the Transaction Cycle Approach and the Organizational Structure Approach. These two options, which are mutually exclusive, are below. Other approaches may be used when they are reasonable and documented.</p> <ul style="list-style-type: none"> <li>• <b>Transaction Cycle Approach</b></li> </ul> <p>Segmenting the agency by transaction cycle results in broad assessable units such as the revenue cycle, disbursement cycle, reporting cycle and budget cycle, and cut across organization lines. A transaction cycle is a stream of related events and processes satisfying one overall functional need of the agency.</p> <ul style="list-style-type: none"> <li>• <b>Organizational Structure Approach</b></li> </ul> <p>Segmenting along organizational lines involves delegating internal control responsibilities to managers in accordance with the formal organization line. The following factors are considered in segmenting the agency into assessable units on an organization basis.</p> <ul style="list-style-type: none"> <li>• Organization Chart</li> <li>• Geography of Units</li> <li>• Independence of Function</li> <li>• Commitment of Program Dollars</li> <li>• Number of Personnel</li> </ul>

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## Internal Control, Continued

### Recommended Evaluation Approach (continued)

Step	Action
3	<p><b>Conduct Risk Assessments:</b></p> <p>The next step in the internal control evaluation process is to assess the vulnerability of each assessable unit to key problem areas such as waste, loss, unauthorized use, or misappropriation of resources. The manager of an assessable unit is responsible for identifying the major risks associated with the unit's activities and assessing the techniques in place to mitigate identified risks. One purpose of the risk assessment is to identify assessable units which have the highest level of risk.</p> <ul style="list-style-type: none"> <li> <b>Risk Assessment - Impact and Schedule</b> <p>As a rule, assessable units having a high-risk assessment rating would be identified for immediate internal control reviews, unless another suitably detailed review has been performed within the past two biennia. It should be noted that although the risk assessment is designed to aid in the scheduling of internal control reviews, often weaknesses in controls become apparent during these assessments and managers should take necessary action to schedule their correction.</p> <p>The frequency of the performance of risk assessments will vary with the susceptibility of each activity to problems such as waste, loss, unauthorized use, or misappropriation of resources. However, it is recommended that risk assessments be performed at least annually. Other factors, such as material changes in the organizational structure, personnel, automated systems or financial resources of an assessable unit may affect the timing and frequency of the risk assessment. These material changes usually require a new risk assessment be performed for the assessable unit. Each agency should also review the comments in the Auditor of Public Accounts' audit report to ensure that each comment is addressed.</p> <p>To ensure that risk assessments are scheduled and conducted in a timely manner, in-depth plans and schedules should be prepared in advance of the assessing year. Each agency's Internal Control Coordinator should coordinate an overall agency plan for completing the risk assessments with the agency head and assessable unit managers.</p> </li> </ul>

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## Internal Control, Continued

### Recommended Evaluation Approach (continued)

Step	Action
3	<p><b>Risk Assessment — Results and Subsequent Actions</b></p> <p>The results of the risk assessment should be reviewed by the Internal Control Coordinator and the respective assessable unit manager. The potential impact of the weaknesses and risks identified in the assessment should then be evaluated and subsequent actions developed, if necessary.</p> <p>Examples of subsequent actions include</p> <ul style="list-style-type: none"> <li>• updating policies or procedures,</li> <li>• providing training, and,</li> <li>• conducting an internal control review. In all cases where an assessable unit is deemed "highly vulnerable," subsequent actions should include an internal control review, unless the assessable unit has undergone an audit by the internal auditors, or the auditor of Public Accounts, or a control review has been recently conducted.</li> </ul> <p>Examples where no action should be taken to address internal control weaknesses are as follows:</p> <ul style="list-style-type: none"> <li>• Cost to implement the recommendation exceeds the benefits gained. However, if a legal mandate requires that the control(s) be in place even though costs exceed perceived benefit, you must take action.</li> <li>• Overall vulnerability in the area is low.</li> <li>• An audit or management review was conducted of the activity within the last two biennia and the resulting recommendations are still being implemented at the time the risk assessment is performed.</li> <li>• A significant management initiative is underway to change the controls in the activity.</li> </ul> <p>Forward corrective action status reports to the Internal Control Coordinator periodically.</p>

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## Internal Control, Continued

### Recommended Evaluation Approach (continued)

Step	Action
4	<p><b>Conduct Internal Control Reviews</b></p> <p>Internal controls for selected assessable units are reviewed to ensure that the defined control activities are functioning as intended and are efficiently and effectively meeting the established control objectives. An internal control review includes the following steps:</p> <ul style="list-style-type: none"> <li>• <b>Identification of event cycles</b> – Identifies the logical workflow pattern of each unit.</li> <li>• <b>Analysis of the general control environment</b> – Determines its impact on the event cycle(s).</li> <li>• <b>Documentation of each event cycle</b> – Provides a clearer view of tasks in each cycle, using flowcharts, etc.</li> <li>• <b>Initial evaluation of internal controls</b> – Assesses the adequacy of the control activities in satisfying the event cycle's control objectives. See "Examples of Internal Controls" below.</li> <li>• <b>Testing of internal controls</b> - Determines if control activities are ... <ul style="list-style-type: none"> <li>• performed in accordance with documented policies and procedures</li> <li>• performed by knowledgeable personnel in well-defined, segregated duties</li> <li>• performed with proper approval and are coordinated with the agency's missions and goals</li> <li>• accomplishing stated control objectives, thereby reducing material risk of waste, loss, unauthorized use, or misappropriation of resources, and</li> <li>• accomplishing control objectives in an efficient and effective manner.</li> </ul> </li> <li>• <b>Reevaluation of internal controls</b></li> <li>• <b>Reporting the results of the review to the Agency Head.</b></li> </ul>

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## Internal Control, Continued

### Recommended Evaluation Approach (continued)

Step	Action
5	<p><b>Take Corrective Actions</b></p> <p>The reported findings and recommendations resulting from the internal control reviews are analyzed. Corrective actions for improving internal controls are scheduled after it is determined that the anticipated implementation cost will not exceed the expected benefit.</p> <p>All costs, including opportunity costs, should be considered. Corrective action status reports should be forwarded to the Internal Control Coordinator on a periodic basis, as deemed necessary.</p>
6	<p><b>Follow-Up</b></p> <p>The agency should perform a 30 or 60-day follow-up analysis to determine if the corrective action taken to address an internal control weakness is functioning properly, especially when another internal control review may not occur for another year.</p>

### Examples of Internal Controls

The following are Internal Control Examples.

- ORGANIZATION CONTROLS
  - Personnel Standards
  - Organization Plan
  - Culture
- SYSTEM DEVELOPMENT AND CHANGE CONTROLS
- AUTHORIZING AND REPORTING CONTROLS
  - Budgeting
  - Accountability

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## Internal Control, Continued

### Examples of Internal Controls

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- SAFEGUARDING CONTROLS
    - Protect assets
    - Avoid risk
  - MANAGEMENT CONTROLS
    - Adequate supervision
    - Management information
  - DOCUMENTATION CONTROLS
    - Formal policies and procedures
    - Systems documentation

## Records Retention

### Records Retention

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Internal control evaluations and associated documentation should be maintained on file for five years.

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## DOA Contact

### Contact

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